Office of Chief Counsel
Internal Revenue Service

memorandum

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date: SEP 20 1999

to: Chief, Examination Division, Southwest District
Attn: William Kennedy

from: District Counsel, Southwest District, Phoenix

ıbject: [redacted] **Maintenance Reserve**

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ISSUE

Whether amounts received as accumulated supplemental rent upon purchase of an aircraft constitute income to the taxpayer.

CONCLUSION

Such amounts constitute income to the taxpayer.

FACTS

The taxpayer purchased a [redacted] aircraft during [redacted]. The stated purchase price for such aircraft was $[redacted]. Coincidently, the taxpayer appraised the plane at the time of the transaction at $[redacted]. At the time of the purchase, the aircraft was subject to a lease to [redacted]. As we understand is common in the industry, the lease included a provision for "supplemental rent," with the intention that such amounts would provide lessor amounts with which to pay for anticipated maintenance on the aircraft. The amounts received by the lessor as supplemental rent were not required to be segregated from other funds, and the lessor had total control of these amounts. These amounts, even though technically unrestricted, were intended to cover the future maintenance costs of the aircraft. When the aircraft required service, the lessee would obtain such service, and then either seek reimbursement from the lessor or send the bill to the lessor for payment.

At the time of the taxpayer's purchase of this [redacted], the prior owner had accumulated about $[redacted] of supplemental rent which had not been required for maintenance or repairs of the aircraft. Upon receipt of the taxpayer's $[redacted] for the aircraft, the seller paid the taxpayer $[redacted] representing this accumulated supplemental rent. It is the taxpayer's usual practice to report supplemental rents as income when received. In the present case, however, the taxpayer did not include the $[redacted] in income, but instead reduced basis in the airplane by $[redacted]. As a substantial portion of airplane maintenance expenses must be capitalized rather than deducted, such treatment has a significant effect on taxable income for [redacted]. You are proposing to increase basis in the aircraft to $[redacted] and to require the taxpayer to report the $[redacted] of supplemental rents received at the time of purchase as income. This would also result in the taxpayer being allowed to deduct or capitalize all amounts spent on maintenance or repair, depending on the nature of each such expenditure.

DISCUSSION

We initially note that the purchase agreement clearly states that the purchase price of the aircraft is $[redacted]. The appraisal provides further evidence that the unambiguous document actually meant what it said. Several principles of law should prevent the taxpayer from asserting that the purchase agreement does not mean what it says, such as the parol evidence rule (see, e.g., Taylor v. State Farm Mutual Automobile Insurance Co., 175 Ariz. 148, 854 P.2d 1134 (Ariz. 1993)); the so-called Danielson rule, under which the Service reserves the right to bind parties

to the specific terms of their contract (Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967); and the rule that a taxpayer cannot challenge the tax consequences of an agreement voluntarily and knowingly made (Baxter v. Commissioner, 433 F.2d 757 (9th Cir. 1970). We therefore believe that it should not be seriously disputed that the basis of the aircraft is $[redacted].

The effect of this conclusion on the present issue is that the taxpayer should not be allowed to assert that the receipt of $[redacted] merely constituted a reduction of purchase price. The taxpayer has received cash of $[redacted], with no restrictions on its use. At its most basic, I.R.C. § 61 provides that gross income means all income from whatever source derived. We are unaware of a specific exception which would be applicable to this section. Similarly, I.R.C. § 451(a) provides as a general rule that the amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless such amount is to be included in a different period under the taxpayer's method of accounting. Admittedly, it was anticipated that the taxpayer would at some point have expenditures roughly corresponding to the amount received. When that point comes, we believe that the taxpayer would be allowed to deduct or capitalize such expenditures, depending on the nature of the work performed. We believe that such a result properly acknowledges receipt of substantial sums, and allows the taxpayer to offset such receipt when expenditures are actually made. Such result also ensures that subsequent capital expenditures will be recaptured over their life, instead of washed out immediately as would be the case under the taxpayer's proposal.

We believe that this situation can be analogized to that of extended warranties. Just like our present situation, an extended warranty typically involves receipt of payment up front, with anticipated expenditures at some point in the future. In that context, it is well established that amounts received are income when received, and that anticipated future costs do not allow such a taxpayer to exclude amounts received from income. Schlude v. Commissioner, 372 U.S. 128 (1963); American Automobile Association v. United States, 367 U.S. 687(1961). We believe that these principles apply equally to the present situation, and that the taxpayer should be required to include amounts received as supplemental rents in income.

We further note that I.R.C. § 446 provides specific rules for how a taxpayer changes its accounting methods. As indicated above, it is our understanding that the taxpayer regularly included amounts received under similar clauses in other leases

in income when received. While we believe that this issue should be resolved under the previously stated principles, the taxpayer's failure to include the amounts at issue constitutes a change in its method of accounting for such items. I.R.C. § 446(e) generally requires a taxpayer wishing to change its accounting method to secure the consent of the Secretary before computing taxable income under the new method. In the present case, the taxpayer has not sought such consent. We therefore believe that this constitutes further grounds for including the receipt of $[redacted] of supplemental rents in income.

We also note that you have advised us that the taxpayer has raised as an affirmative issue its inclusion on its return of similar (but much smaller) amounts received in connection with two other aircraft purchased during the current cycle. These two situations differ from the present in that the parties netted the amounts at closing, i.e., rather than trade checks as done with the purchase of the [redacted], the taxpayer subtracted accumulated supplemental rents from its check for the airplane. We fail to see how such offset changes the character of supplemental rents, or allows the taxpayer to assert that it did not actually receive the supplemental rents. This is not even a question of form over substance, as we believe that both the form and substance of the transaction is reflected in the purchase agreement. It is merely an offset of liabilities; the taxpayer owes the seller the purchase price, and the seller owes the taxpayer accumulated supplemental rents. The netting of these amounts does not affect the tax consequences of these separate elements. It would not allow the seller to report reduced gain based on the net amount received, and it should not allow the taxpayer to escape the consequences of the accumulated supplemental rents. The taxpayer received benefit from these amounts: specifically, the taxpayer was required to remit amounts less than the full purchase price because of the netting of these supplemental rents which it was to receive. We are therefore puzzled why a sophisticated taxpayer would suggest that the mere fact of netting offsetting mutual debts, as opposed to trading checks, would alter the tax consequences of the affected transactions.

Please note that we consider the advice rendered above to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days

to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions regarding this matter, please contact me at (602) 207-8052.

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